

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

Price Elasticities and Internet Diversion)

Docket No. RM2014-5

COMMENTS OF THE ASSOCIATION FOR POSTAL COMMERCE

(September 19, 2014)

Pursuant to Postal Regulatory Commission (“PRC”) Order No. 2117, the Association for Postal Commerce (“PostCom”) submits these comments on the pricing elasticity model developed by PRC staff included as Attachment A to Order No. 2117 and presented at the technical conference held on August 13, 2014.

I. INTRODUCTION

The ability to forecast the demand for products and services, as well as to determine the appropriate price to charge in light of that demand, is fundamental to any business, whether public, private, or governmental. The ability to forecast accurately depends, however, not only on the availability of historically accurate information, but also on a keen insight into how the business’s customers ultimately make decisions. In the case of the Postal Service, these customers are primarily those who use mail for business communication and commerce. While the use of historical information has some value in the construct of any demand model, that value is greatly diminished if the model fails to reflect all of the relevant changes that have affected the business communication and transactional marketplace. As the model presented by the Commission staff at the August technical conference failed to reflect or account for the changes the mail marketplace has undergone over the past decade, it does not accurately capture the factors that drive postal customers’ decisions regarding their use of the mail. Accordingly, the model developed by the Commission staff will provide little value in forecasting future demand for the Postal Service’s products.

These failures in the Commission staff model are particularly troubling given that the utility of any elasticity model for the Commission lies solely in its ability to inform the Commission about how mailers are likely to react to changes in Postal Service prices. That is, while understanding the demand characteristics of its products is of significant value to the Postal Service in determining how to exercise its pricing flexibility, the Commission’s limited role in reviewing price changes diminishes the need for detailed Commission analysis of demand factors. Within the price cap, the Postal Service is free to set prices as it wishes, regardless of the elasticity of those products and the impact of its price changes on mail volumes. Thus, while a demand model may be informative for the Commission, and may have limited application in aiding the Commission in reaching decisions regarding appropriate workshare discounts, negotiated service agreements, and price changes for “underwater” products, the utility of the model for evaluating standard price changes is limited to non-existent.

II. THE MODEL RELIES ON FAULTY ASSUMPTIONS

There are a number of fundamental flaws with the model presented by the Commission's staff at the technical conference held in August 2014. We discuss several of the most important below.

A. The Branching Points Model Does Not Reflect Mailer Behavior

In description of its method, the Commission staff makes reference to branching points that it claims “correspond[] to a hypothetical budget process for an average mailer.”¹ The model, however, assumes that “determining expenditures by class, requires an average mailer to know only its total expenditure on domestic mail, the price indices for domestic mail classes and other pre-determined conditions represented by exogenous variables.”² This assumption oversimplifies mailers’ decision processes to the point that its utility must be called into question. Although many times the decision to mail with one mail class of service rather than another is a simple business decision based on price factors, at other times, this class-based decision is dictated by postal, state, or other regulatory rules or laws. That is, decisions made regarding the shape of mail piece or the level of worksharing are not as simple and straight-forward as the Commission staff has assumed. Similarly, and perhaps more fundamentally, the assumption that mailers have “an aggregate budget for domestic mail,” rather than a budget for communication via any media, is unduly reductive of mailers’ decisions.

The model therefore assumes behaviors by mailers that do not accurately reflect how mailing decisions are made. These faulty assumptions are not surprising, as Commission staff never contacted or interviewed mailers to learn how decisions are actually made in developing a mail campaign. The benefit of real-world mailer input could have provided information that could have imbued the staff's work with greater value.

B. Competitive Product Impacts

In the Tree Branching Structure³, there were six classes of mail identified by the Commission staff: First-Class Mail, Standard Mail, Express and Priority Mail, Periodicals Mail, Standard Nonprofit, and Package Services. There are issues with how the Commission staff segmented the classes. Most importantly, the inclusion of competitive classes in the structure is problematic given that Commission staff relied on only market-dominant data in developing its elasticity figures. Commission staff relied on publicly-available data, excluding data on competitive products and competitive volume under contract where those volumes and prices were under seal.

As Commission staff relied only on market-dominant information, it should have constructed a model designed to reflect only market-dominant elasticities. The extension of the

¹ “A Branching AIDS Model for Estimating U.S. Postal Price Elasticities” at 2.

² *Id.*

³ “A Branching AIDS Model for Estimating U.S. Postal Price Elasticities,” Figure 1: Tree Branching Structure for U.S. Domestic Mail.

model to competitive classes is inappropriate without data on competitive volume and price. Additionally, competitive products are subject to different statutory and regulatory requirements regarding pricing, reporting, and contracting than market-dominant products which are not accounted for in the model.

Finally, the structure of the model fails to account for the move of Parcel Select and Parcel Return Services from the market-dominant to the competitive category.

C. Broadband Household Penetration

One of the reasons it is so essential for postal demand-based models to understand mailer behavior correctly is because the world has changed considerably when it comes to alternative ways by which a business might conduct its communications and transactions. Clearly, the most significant difference today from 30 years ago is the more diverse methods by which communication and business can be conducted with the rise of a multiplicity of electronic communication alternatives. Consequently, for any postal demand based model to have value, it must be sensitive to and accurately predict a business' decision regarding the use of a mail-based channel as opposed to alternative business communications and transactional media.

As the Commission undoubtedly knows, the nature and availability of ready alternatives to mail have grown significantly over the past two decades. The Commission staff, however, elected to restrict its consideration of non-mail based alternatives (such as the internet) to a simple and undifferentiated determination of household broadband internet penetration. This approach is fraught with several errors.

First, the staff's definition of broadband internet capability is limited. In the manner it was described at the technical conference, it appeared that staff was limiting the definition of broadband household penetration to fixed internet access, *e.g.*, DSL, cable, and fiber internet services. In today's market, however, the big commercial move is to mobile. Consequently, any model that fails to reflect the broader availability of mobile internet services or the manner in which they are commonly used is incomplete.

Further, the staff's approach treated internet broadband household penetration as the definitive measure of the viability of all aspects of internet-based communication and business transactional services as an alternative to mail. Household penetration, however, can be reliably used as a determination of only one thing: the availability of alternative internet-based channels in the business communication stream. To assume anything more than that would be a mistake.

As an analogy, knowing the household penetration of automobile ownership is a great way of knowing how many households may have ready access to an automobile. It does not, however, accurately reflect how frequently or how extensively automobiles are used relative to other transportation or business transactional alternatives such as bus, light rail, or train transportation, or the use of home-based shopping and product delivery services in lieu of actually going to and conducting a transaction at a store.

Similarly, knowing household broadband penetration tells you nothing about when, why, or how often digital electronic services are used. Household broadband penetration information

tells you little about whether or not transactions are occurring via the web, SMS, Twitter, Facebook, LinkedIn, or any of another number of alternative digital electronic channels.

In today's world, the ability to accurately determine the cross-price elasticity of any mail service must include accurate information about cross-price elasticities across all alternative vehicles. Furthermore, to calculate any of those cross-media elasticities in any way that would be meaningful requires some knowledge of the own-price elasticities of each of the digital alternatives. As most modern businesses know, you don't use SMS the same as you do Twitter, and you don't use Twitter in the same way and with the same audiences (necessarily) as you do with Facebook. It is too great a simplification to lump all of these channels under the single category of "broadband internet" and to rely on statistics regarding broadband internet penetration to capture the use of these disparate platforms.

D. Why Is Any "Fit" Needed

By the Commission staff's admittance, neither the trunk equation nor the AIDS share equation accurately modeled demand elasticities; both needed "fits" in order to get results the Commission staff could conclude were accurate. Further, the Commission staff could not "fit" the equations using ordinary methods, but rather had to construct additional variables and/or use additional "fitting" of reduced form equations. Although these "fits" allow for results the Commission staff believes reflect a high level of detail and accuracy, the need for such "fits" raises questions regarding the intrinsic value of the equations and the quality of the inputs into the equations. Is postal data accuracy an issue? Is the format in which data is collected, segmented, and reported an issue? Where do the issues exist within the collection of variables such that the Commission staff needed to "fit" equations? Commission staff has not provided answers to these questions sufficient to provide confidence that the equations are properly describing mailer behavior.

III. RESULTS SHOULD BE TESTED BEFORE MOVING FORWARD

In its paper, the Commission staff states that "the modeling results demonstrate that modern econometric methods are capable of producing complete matrices of postal price elasticities at a high level of detail and accuracy."⁴ Yet, when asked if the modeled results were compared to actual postal results over the last few years, the Commission staff admitted that no such comparison had taken place.

At this point, PostCom is wary of moving forward with any other discussion or modeling until modeled results against actual results are reported out and discussed among the industry in another technical conference. How can the industry engage in discussions of a model without seeing the results of such a model compared to the actual results over the last few years?

Another fruitful exercise would be to use this model to forecast 2015 and 2016 demand and then compare to what actually happens in 2015 and 2016.

⁴ "A Branching AIDS Model for Estimating U.S. Postal Price Elasticities" at 1.

IV. CURRENT REGULATORY ENVIRONMENT LESSENS THE IMPACT OF MODEL FORECASTING

With the passage of the Postal Accountability and Enhancement Act of 2006, the Postal Service has changed its pricing strategy to reflect the realities of the Act. Gone are the days of before- and after- rates with test-year productions and break-even analysis. It is now faced with a price cap that allows USPS management extensive pricing flexibility with limited regulatory interaction outside of cap compliance.

Although mailers are not involved in postal price setting, it is clear that elasticity figures and demand equations, although important, do not play the central role they once did under the previous postal law. These figures are even filed separately, in their own report, from price and product requests.

However important the Commission staff views these figures or the application of such models, mailers are left to question whether this importance carries over to decision-making within the Postal Service. The price cap has played a major role within the mailing industry to provide predictable, reliable, and consistent postal rates over the last eight years. While it is of course useful for the Commission to understand how mailers make their decisions and what influences changes in postal prices can have on those decisions, it is not clear what practical impact—from a regulatory or market perspective—updated demand and elasticity models will have.

In addition, the PAEA environment has pushed the Postal Service to increasingly exercise its pricing flexibility in innovative ways, through the introduction of discount rates and the development of NSAs. While improved demand models could be theoretically useful in this context, to help understand the impact of such rates on mailer volumes and behavior, the practical utility of the models is limited in terms of their ability to assist the Commission in its decisions to approve or reject such rates. In these instances, the Commission can better serve mailers, the Postal Service, and the public by deferring to the business judgment of the Postal Service. Superseding the Postal Service's judgment and requiring NSA and other discounted rates to conform to demand models designed to broadly reflect mailer behavior as a whole (and not the circumstances of individual mailers) would unnecessarily impede mailer-Postal Service cooperation that could play a significant role in growing mail volumes.

V. CONCLUSION

In the price cap environment established by the PAEA, the role of demand and elasticity models in the Commission's decision making is unclear. To the extent that such models may be useful, however, they must accurately reflect how business mailers design campaigns, distribute resources, and choose among competing media to convey their messages. As the model presented by the Commission staff in this proceeding falls short in each of these dimensions, the Commission should not rely on it as an accurate representation of the elasticity of postal products. While PostCom supports the Commission's efforts to better understand mailer behavior and the relationship between mailers and the Postal Service, the Commission staff model simply does not advance this understanding.

Respectfully submitted,

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